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International Outlook 1986

Economists with major U.S. corporations participating in The Conference Board's tenth annual survey on the international economic outlook, presented this year in a new format, predict continued modest growth in the principal industrial countries during 1986. According to these economists and a few of their European colleagues, who were polled in late September/early October:

- Real economic growth will average between 2.3 and 2.5 percent in Europe, around 2.5 percent in Canada, and 3.5 percent in Japan.
- Inflation will moderate to around 5.5 percent in Europe, remain unchanged at 2.5 percent in Japan, and increase slightly to 4.5 percent in Canada.
- The dollar will weaken further, albeit gradually, against other major currencies throughout 1986.

Modest Growth Ahead

The overall picture emerging from the survey is slightly less optimistic than the 1986 forecasts of such official organizations as the International Monetary Fund and the Organization for Economic Cooperation and Development (OECD). In fact, in view of the general world economic situation, the survey results can even be characterized as slightly disappointing.

For one thing, the survey reveals that any slack that might appear during 1986 in U.S. import demand will not be taken up by vigorous business activity in the other industrial countries. Nor do the business economists and strategists believe that the commitments made at the September 22 G-5 summit meeting by such major players as Germany and Japan ("strengthening the underlying conditions for continuing, vigorous, job-creating growth" and "institute policies intended to insure sustainable noninflationary growth") will be implemented in 1986.

Forecast Highlights
1986 GNP Growth
Four European Countries

France	2.0%
Germany	3.0
Italy	2.2
United Kingdom	2.4

Panelists noted a considerable degree of convergence in economic activity abroad. Accordingly, they expect relatively little difference in the performance of individual economies. For the six major countries outside the United States, their median projections range only between 2.0 and 3.5 percent. That dispersion contrasts with an estimated range of 1.6-4.5 percent for growth in 1985 (Table 1).

Germany is viewed as likely to record a three percent growth rate in 1986 (up from 2.5-2.8 percent in 1985), as higher domestic investment and consumption replaces the strong export performance of the past few years. That is a little lower than the official forecast of nearly 3.5 percent and is not compatible with a significant decline in either Germany's unemployment rate or trade surplus. The French economy likewise will probably show slightly faster growth in 1986 than during 1984-5. While Japan will grow faster than both the United States and Europe, its performance in 1986 could well be lower than in 1985 unless the authorities adopt additional and stronger expansionary measures. According to many panelists, the October 1985 economic stimulus package is unlikely to make up for the demand provided by exports over the past three years.

Forecast Highlights
1986 Inflation Rates
Four European Countries

France	5.5%
Germany	2.5
Italy	9.0
United Kingdom	6.0

Italy and the United Kingdom, on the other hand, are likely to slow down this year, as will several of the smaller European economies. In addition, in France,

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TABLE I

Forecasts: Gross National Product and Prices
(Annual rates, in percent)

		1984 Actual	*1985 Estimated*	*1986 Projected Median*	*1986 Projected Range*
Canada:	GNP	4.7	3.1	2.5	0.0 to 3.0
	CPI	4.3	4.1	4.5	3.8 to 6.1
France:	GNP	1.7	1.6	2.0	1.0 to 3.5
	CPI	7.4	6.0	5.5	4.5 to 8.0
Germany:	GNP	2.6	2.8	3.0	2.2 to 4.0
	CPI	2.4	2.5	2.5	1.5 to 3.6
Italy:	GNP	2.6	2.5	2.2	2.0 to 3.5
	CPI	10.8	9.0	9.0	6.5 to 11.0
Japan:	GNP	5.7	4.5	3.5	3.0 to 5.0
	CPI	2.3	2.5	2.5	1.5 to 3.7
United Kingdom:	GNP	1.6	3.1	2.4	1.5 to 4.5
	CPI	5.0	6.0	6.0	5.0 to 6.5

Germany and the Netherlands election campaigns will overshadow economic policy issues in 1986.

The fight against inflation has been more encouraging than efforts to stimulate growth, with the average annual inflation rate for the EC declining by over 6 percentage points between 1980 and 1984. A significant reduction in unit labor costs, plus the gradual decline of the dollar, are expected to lower the private consumption deflator from an average of 6.3 percent and 5.4 percent in 1984 and 1985, respectively, to 4.4 percent in 1986. Inflation rates are expected to decelerate in all member countries, except Italy and the United Kingdom, and should range from 2.0 percent in the Netherlands to 17.0 percent in Greece. Still, the overall decline in inflation in Europe is seen to be less than might have been expected given the considerable decline in the dollar that has already occurred.

Some Further Weakening of the Dollar

The majority of panelists expect a further, but gradual, weakening of the dollar against major currencies throughout 1986. The case for some additional weakening against the yen looks particularly strong, since the Japanese economy is expected to post one of the highest growth rates and the lowest inflation rate among the industrial countries.

But, according to the survey, the dollar's overall decline is projected as modest, with the dollar opening the year on a strong note, declining somewhat through much of the year, and then bottoming out toward year-end. An extreme view, not generally shared, sees a 20 percent decline against the D-mark and the French franc and a 15 percent drop against the British pound.

A trade-weighted depreciation between 5 and 10 percent in 1986, it was noted, would bring the dollar back to its average level of 1982 and, incidentally, just slightly below its value in 1971, before the demise of the fixed-rate system. All in all, the panel's exchange-rate projections for 1986 would not restore full international competitiveness to U.S. industry which, according to most economists working on the topic, would require a downward correction of around 25 percent from September 1985 levels.

But, one respondent remarked, the positive effects of the dollar decline in 1985 should not be shrugged off. Multinationals with large overseas operations—such as drug, personal-care, and computer companies—will now be able to report sizable

currency-translation gains. Simply put, their foreign earnings will be worth more to their shareholders.

The panelists felt that central-bank intervention to bring the dollar down, as agreed on at the end-of-September G-5 financial summit, could not guarantee an orderly major downward correction if the necessary reduction in the U.S. budget deficit was not brought about. In fact, because of uncertainties in intervention policy, U.S. budget policy, and U.S. business activity the dollar exchange rate itself will remain subject to uncertainty.

Yet, the panelists agreed, the timing of the G-5 meeting had been critical, since it was easier to push the dollar lower when it already was falling that when it was rising. Moreover, since the dollar already was weakening at the time, any rebound probably would be very modest. All in all, however, the readjustment of exchange rates is considered to be largely over for the time being.

Finally, it was pointed out, a lower dollar by itself does not induce faster growth abroad—it simply gives the authorities some leeway for more reflationary policies. Put differently, central-bank intervention can be useful in moving exchange rates in a more reasonable direction from the standpoint of achieving a better trade pattern. But it cannot take the place of appropriate domestic policies to maintain adequate economic expansion abroad.

Mixed Outlook for Major Industrial Countries

In forecasting economic activity and inflation rates for the six major industrial countries outside the United States in 1986, the panelists provided a fairly wide range of estimates—although, as pointed out, the midpoint projections for the six countries fall within a relatively narrow compass. Their qualitative comments discuss some of the fundamental factors in each country's performance.

Japan

Interest naturally focused on Japan, both because of the country's importance in the world economy and the sensitivity of U.S.-Japanese bilateral relations. Signs of weakness were detected in Japanese business, which was suffering its first drop in pretax profits in three years. Yet, capital expenditures remain healthy and are starting to be accompanied by a rise in personal consumption. The government also is reviving some large-scale construction projects left over from the previous administration.

Survey respondents feel that these expansionary trends and policies will be moderately effective, but that they cannot fully substitute for a drop in export earnings. In fact, while the government program announced in mid-October implies Japan's recognition of the need for expansionary measures, official claims of the program's impact on the economy in 1986 are considered exaggerated. Some of the proposed expenditures were already in effect; other measures merely bring spending forward from late 1986 or early 1987. The program's total impact is estimated to be no more than ½ percent of GNP, spread over two years, but concentrated in the first half of 1986. Moreover, some of the program's potential effects have been offset in part by the jump in Japanese interest rates in late October.

The Japanese economy is seen as remaining clearly outward oriented and dependent on international trade to realize its full potential. Flush with excess savings, state-of-the-art technology, and a thriving automobile industry, it cannot afford to do without a major export sector for long. Japan is resourceful enough, moreover, to look beyond the United States and Europe to China and other countries for its trading future.

The panel agrees that foreign tolerance of Japan's market penetration has come close to the breaking point. With the government taking steps to both restrain sales abroad and boost imports, business activity will have to rely more heavily on

domestic demand. But that takes time, and without the stimulus of expanding exports growth is bound to slow somewhat in 1986.

Germany

The 1986 outlook for Germany is generally characterized as "good" or even "strong". But these judgements merely make a comparison with 1985, when the economy grew by 2.8 percent. The projected growth of 3.0 percent or marginally higher is not remarkable by historical standards, nor is it sufficient to impart a much needed boost to Europe as a whole—although German officials appear to believe that their economy is booming. They feel, moreover, that it should not have to serve as a locomotive for the rest of the world.

The modest growth in 1986 is seen as being fueled mainly be private consumption as wage settlements are likely to be somewhat more generous than in 1985; a small cut in income taxes will benefit wage and salary recipients; and transfer payments will show a marked increase. A number of panelists, however, see an urgent need for a more ambitious reform of corporate taxes, aimed at removing distortions and creating a better investment climate. Some room for tax reduction, it is believed, might be found through a cut in government subsidies, which according to one recent estimate equaled 6½ percent of GNP and were available to numerous sectors, including agriculture, mining, aerospace, shipping and railroads.

Yet, the government has ruled out any radical tax reform during its term in office, but has chosen a two-step approach. The first stage, in 1986, includes a slight cut in personal income taxes, some preferential treatment for owner-occupied dwellings, increased family allowances, and easier access for small- and medium-sized businesses to risk capital. The second and somewhat more comprehensive part of the package is to be implemented in 1987-88, after the next general election.

This past October, the five leading German research institutes urged the government to advance the second stage to 1987. The government, however, shows no indication of following this recommendation.

France

The survey depicts France in a somewhat less favorable light than the country appears to deserve. There have been some notable improvements during 1985—in the inflation rate, in corporate profits, in productivity, and in the external accounts. In fact, by the year-end—just three months before the parliamentary election—economic prospects looked considerably brighter than they had for some time (survey responses, it must be noted, were prepared in the early fall).

Respondents tended to focus on the three years of austerity since Mitterand's Socialists came into office and stressed that the country was lagging behind its European neighbors in growth, while its inflation rate remained among the highest. Moreover, they pointed out, developments beyond the country's borders were now threatening to rob the economy of a major source of strength—exports.

Even a political realignment next March, it was felt, might not improve economic conditions immediately, since the need to contain inflation would keep government spending on a tight leash. One major impediment to faster growth that was cited is the rigidity of the overall regulatory environment; it remains difficult to shift human and physical capital from one use to another. In fact, as a manufacturing location France has the twin disadvantages of a relatively high labor cost base and relatively inflexible labor laws and price controls. A center-right majority next March would probably relax price controls somewhat; on the other hand, if inflation approached the ten-percent level controls might be tightened again, regardless of what party was in power.

Internationally, the French economy is too open and too much tied to the rest of Europe to be able to grow considerably faster than the European average. One

panel member predicts a 6 percent devaluation of the franc within the European Monetary System—even though the economic policy implications of a center-right victory in March would favor the franc.

Italy

In their outlook for Italy, the survey respondents display a tone of guarded optimism, even though in statistical terms they project somewhat lower growth in 1986. Panelists cite the apparent stability of the current government; a greater degree of common sense on the part of the trade unions; and a return to profitability in the corporate sector.

The panel concedes that inflation in Italy is still much higher than in the other industrial countries. But it notes that the inflation rate declined by four percentage points in 1984, another two points or so in 1985, and, barring a rise in the international price level, could decline to as low as 6-8 percent in 1986—arround current levels in Scandinavia.

Several panelists stress, however, that the economic picture is by no means all favorable. First, Italy has the largest government deficit among major industrial countries—equivalent to about 45 percent or more of revenues. The public debt itself is about the same size as the country's national income, and interest payments on the debt take up more than half of government spending. No long-lasting solution to this problem is seen forthcoming at this time.

Second, the trade deficit deteriorated rapidly in the first half of 1985 and, despite the devaluation of the lira within the EMS in July, the gap is expected to widen further. A larger trade deficit will increase the county's already high foreign debt and this, in turn, will weigh heavily on the balance-of-payments. Thus, the budget and the external situation are two dark spots on an otherwise slowly improving picture.

United Kingdom

In the United Kingdom, the government's autumn expenditures statement foresees three percent real growth in 1986, an inflation rate below four percent, a sizable rise in disposable income, and a balance-of-payments surplus of £4 billion (roughly $6 bill.) The panel members, as well as most other independent forecasters, are somewhat more pessimistic. They predict growth of around 2.5 percent (a figure also quoted by the Confederation of British Industry) and inflation of at least 4.5 percent, if not higher.

The official forecast assumes that consumer expenditures—which account for three-fifths of GNP—will rise by over four percent in real terms, as a result of income tax cuts in next March's budget, wage increases of between seven and eight percent, and a drop in consumer prices to 3.75 percent by the fourth quarter of the year.

The major difference between the government's and the panel's estimates concerns the rate of inflation. The official forecast assumes that unit labor costs will rise by no more than five percent (despite a seven to eight percent increase in earnings!) and that sterling will remain firm even if oil prices decline further.

The panel members also see slower growth ahead, in part because of the ending of accelerated depreciation allowances next March. As a result, capital spending is expected to rise by no more than two percent in 1986, as against the government's more optimistic four percent.

In addition, a few panelists feel that net exports in 1986 will be somewhat less buoyant, since their good showing in 1985 reflected the ending of the miners' strike and competitiveness gained from sterling's decline through 1984—factors that are not likely to recur in 1986.

On the plus side, panelists cite the government's policy goals of privatization and reduced financial aid to industry, which will make further progress over the next three years. With the government planning to raise $6.75 billion in each of the next three fiscal years from the sale of state-owned firms (as against $3.6 billion in the year ending in March 1986), it has been suggested that such sales might be treated as a form of covering official borrowing needs and thus relieve the budget.

Canada

Prospects for Canada are somewhat muted. The panel expects that GNP growth in 1986 will slow to 2.5 percent as major tax increases take effect. Significant increases in both personal income and consumption taxes will adversely affect consumer spending. Moreover, the increase in the Federal sales tax will boost the inflation rate to at least 4.2 percent.

Foreign investment in Canada is expected to remain sluggish until the authorities can convince foreign investors that the new "economic pragmatism" is for real. Moreover, panelists feel that the tax increases and spending cuts built into the 1986 budget can only serve to instill a more cautious attitude into foreign investors.

For the medium term, however, the free-trade negotiations between the United States and Canada are seen as a major opportunity for multinational corporations active in both markets as well as for new investors seeking a foothold in Canada. When officials from both sides resume informal meetings early in 1986, they will focus on a comprehensive arrangement that would phase out all remaining tariffs over ten years. Canada is expected to propose a joint body to arbitrate cases involving nontariff barriers. Eventual implementation of these arrangements, the panel concludes, will mean fewer impediments to the conduct of corporate operations across the border and provide a much more stable planning environment.

Other Countries

Some panelists provided projections for a few smaller industrial countries and some major developing ones. The basic contours of those projections are (1) a relatively better economic performance in some developing countries than in industrial ones, and (2) continuation of the "dual nature" of inflation in the developing world, with high rates in major Latin American debtor countries and much more moderate rates in some newly industrializing countries in Asia (Table 2).

TABLE 2

Selected Projections of GNP and Price Changes, 1986, for Smaller Industrial and Major Developing Countries (Annual rates, in percent)

	Real GNP	*Consumer Prices*		*Real GNP*	*Consumer Prices*
Australia	3.6	7.0	Argentina	−1.0	260.0
	3.0	6.5		0.0	200.0
Belgium	2.0	6.0	Brazil	3.0	200.0
	1.5	5.0		6.0	230.0
Netherlands	2.5	3.0	Hong Kong	4.5	5.5
	2.4	3.0		5.5	5.5
Spain	2.4	7.0	Korea	5.0	5.5
	3.2	6.5		5.0	4.5
Sweden	1.5	8.0	Mexico	3.0	60.0
	2.5	6.8		2.5	55.0
Switzerland	2.8	3.8	Taiwan	4.0	4.5
	2.0	3.0		5.5	3.0

Note: Each set of projections was supplied by one particular panel member.

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